

Outline of an article anent Keynes for Davidson

In my 1975 Book John Maynard Keynes I emphasized that Keynes was the author of a Treatise on Probability long before he wrote the General Theory. The essential characteristic of Keynes's view of probability was that probable knowledge was the result of induction. Induction has two facets.

One is the derivation of propositions about the nature of some aspect of "the world" by weighing and evaluating observations upon the world. Out of a seemingly inchoate set of observations order is derived by induction. A set of such adduced principles or propositions are linked to form a model or theory of the world. However observations on the world do not unambiguously lead to one and only one set of adduced principles; alternative or competing models of the portion of the world under scrutiny can be derived by induction from the observations upon the world by different analysts whose priors, observations and history differ.

The adduced properties of the system can be used to derive postulates from which the adduced properties can be derived. As Adlai Stevenson once put it the logic of lawyers can be summarized as "These are the conclusions from which I draw my premises."

Impact of securitization
on our understanding
of money

Securitization.

Structure of liabilities
used to finance portfolio
assets [enhancing credit
→ transfer to special
Bank reserves] acceptable

lead to

Reserves?

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Models can be visualized as entering a competetion with other models and out of this competetion a particular model becomes the operative model for decisions at a particular date. The events of the world are then used as tests of the validity or usefullness of the operative model for decisions in the world. Inasmuch as the operative model won out in a competetion among models for the state of operative model, the same unfolding data which is used to make judgement about the continuing status of the operative model and the of the emerging observations on the validity of formulations which had been rejected in the past. Events can, have and can be expected to continue to affect the degree of rational belief by an agent in the validity of continuing to use a particular model as the reigning model for decisions. Tagents in the model may modify or even radically change the model, of the model that is the proximate guide to operations

A second facet of probability is that with time unfolding observations change the beliefs of agents about which model it is proper to use in determining decisions.

THus a prime characterisitic of inductive reasoning is that the degree of rational belief in a system which is based upon inferring from observation an understanding of the principles guiding the behavior of agents can nnever achieve

certainty. Once it is accepted that the agents in the model can be unsure about the characteristics of the system then it has to be recognized that the agents in the model can never be sure that a set of principles which was arrived at by a process of induction and which was used as a guide to decision "yesterday" is a valid basis for making decisions today. A scientist needs to doubt the validity not only of the premises of others but also of the propositions in the model of the model that guided his decisions in the past.

Peter Albin characterized the substance of the rational expectations revolution in economics as holding theta "The agents in the model have a model of the model" In the hands of the rational expectations school this assertion about the agents in the market made the perfect foresight assumption, which was necessary for the proof of the proposition that an intertemporal General Equilibrium exists to hold, unnecessary.

Furthermore the existence of a rational expectations equilibrium requires that all of the agents hold the same model to be true and this model models the economy as a general equilibrium equilibrium set up which seeks and sustains equilibrium.

As Sargent point out Rational expectations makes heroic assumptions about the ability of units to draw inferences from observations: He identifies it as a problem in learning the properties of the true model from observations. "Learning" the true or determining an operational model of the economy.

As is well known, the proof that a Rational Expectations equilibrium exists, depends upon the market disciplining agents which make the wrong assumption about the model that rules in the economy.

A NOTE ADJOINED TO MY READING OF DAVIDSON'S "Reality and Economic Theory" revised as of October 4, 1995

HPM agents are unsure about whether the model guiding their decisions truly captures the way the world works. The working or operative theory is the result of inductions: the inductive process begins with a sketch of alternative models and the use of subsequent observations both to modify the models and to give differential credence to different models. When the need to act becomes imperative one of the models is selected as the operative model for decisions. There is a continuing process of both using models for decision. modifying the models as the result of observations, adjusting the degree of credence attached to different models and even changing the model that is operative for decision processes.

Subsequent observations lead to modifying the original model and changing the degree of credence attached to alternative models. A model once in play for the role of the operative model never leaves the memory of the agents.

A monetarist President of a Federal Reserve bank is supposed to have remarked that his great fear is that one day he will wake up and find that "Minsky was right."

The position that data unambiguously leads to one model dominating forever and ever is not consistent with the ambiguity attached to inductive processes.

Economists as they make a claim to being scientists need to back off from positions that there is one true model of the model as we approach it. One reason for abandoning the postulate of a stable base for decisions is the phenomena of institutional change and the impact of institutional change.

Hicks, John R. Economic Perspectives" Oxford 1977 according to Davidson wrote that agents "...do not know what is going to happen and know that they do not know just what is going to happen. As in history"